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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

2 5 JUL 1986

MEMORANDUM FOR: The Honorable William F. Martin
Deputy Secretary of Energy

FROM: [redacted] 25X1
Director of Global Issues

SUBJECT: Near-Term Oil Price Outlook [redacted] 25X1

Bill

In response to your request we have attached our assessment of the near-term oil price outlook. As you know, we think it will be a period of high volatility. If you or members of your staff have questions concerning the report, please call [redacted] 25X1 [redacted] Chief, Energy Markets Branch, OGI [redacted] 25X1

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Attachment:
Near-Term Oil Price Outlook [redacted]
GI M 86-20166, July 1986, [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

SUBJECT: Near-Term Oil Price Outlook

OGI/SRD/EMB/[redacted] (24 July 1986) 25X1

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

24 July 1986

Near-Term Oil Price Outlook

Summary

The oil market during the next six months will be characterized by substantial price volatility. We believe that prices will average between $10-15 per barrel, but we do not expect a smooth pattern. Indeed, prices could plunge well below $10 per barrel followed by quick turnarounds. Under no circumstances do we anticipate that prices will rise above $15 per barrel unless the Saudis decide to drastically change course. At this time there are no signs that Saudi Arabia is prepared to pare production. [redacted] 25X1

This memorandum was prepared by [redacted] 25X1
[redacted] Energy Markets Branch, Office of 25X1
Global Issues, with a contribution from [redacted] 25X1
[redacted] OGI. The information contained herein is updated to 25X1
23 July 1986. Comments may be directed to [redacted] Chief, 25X1
Energy Markets Branch [redacted] 25X1

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[redacted] 25X1

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Near-Term Oil Price Outlook

Recent Developments

OPEC production in June--including natural gas liquids--averaged nearly 20 million b/d, some 3 million b/d above average 1985 levels. Nearly all the gain reflects increased Saudi output which is now hovering around 6 million b/d (figure 1). The only offset to Saudi gains has been a 500,000 b/d - 1 million b/d decline in non-OPEC output due in large part to marketing problems. On the consumption side we estimate non-Communist oil usage during first half 1986 was about 500,000 b/d above last year's levels, less than some oil companies had expected. Delays in passing on lower crude costs combined with sluggish economic growth is for the most part responsible for the modest rebound in oil use. 25X1

OPEC has met four times so far this year to try to resolve its differences over the production sharing issue. In the wake of their latest stalemate last month, spot prices have fallen sharply and are hovering near $10 per barrel--the lowest level in 13 years. We estimate the world average oil price was $12 per barrel last week, compared to $27 per barrel last year. Spot prices have become extremely volatile--often fluctuating by as much as $5 within a few weeks (figure 2). 25X1

Outlook for the Remainder of 1986

The oil market during the next six months will be characterized by substantial price volatility. The interaction of several variables--seasonal swings in oil demand, erratic inventory behavior, producer intentions and market psychology--will determine the extent of price fluctuations. We believe that the net impact of these factors will cause prices to average as low as $10 per barrel, but under no circumstances do we anticipate that prices will rise above $15 per barrel unless the Saudis decide to drastically change course. At this time there are no signs that Saudi Arabia is prepared to pare production. Indeed, prices could plunge well below $10 per barrel for periods of time--particularly if OPEC continues to increase production-- 25X1
followed by quick turnarounds as market forces take effect. 25X1

Price Determinants

Key determinants of price behavior over the next six months will be consumption patterns, inventory behavior, non-Saudi supplies, and Saudi oil production policy. 25X1

Consumption. The consensus view among industry forecasters looks for non-Communist oil consumption to increase at an annual rate of about 2-3 percent during the last half of the year. Almost all of the increase in demand will come from OECD

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Figure 1

Saudi Oil Production

Dominates OPEC Output... ...And Crowds Out Non-OPEC Output

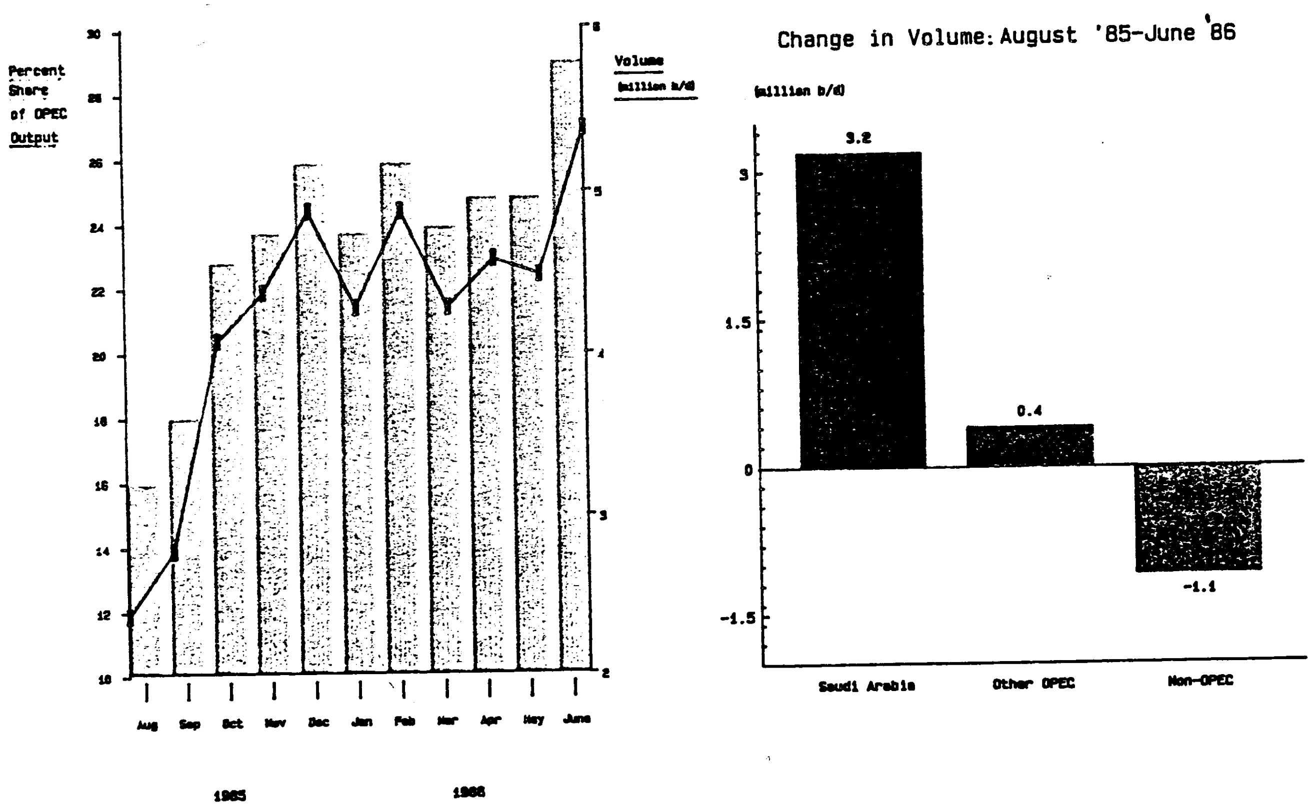
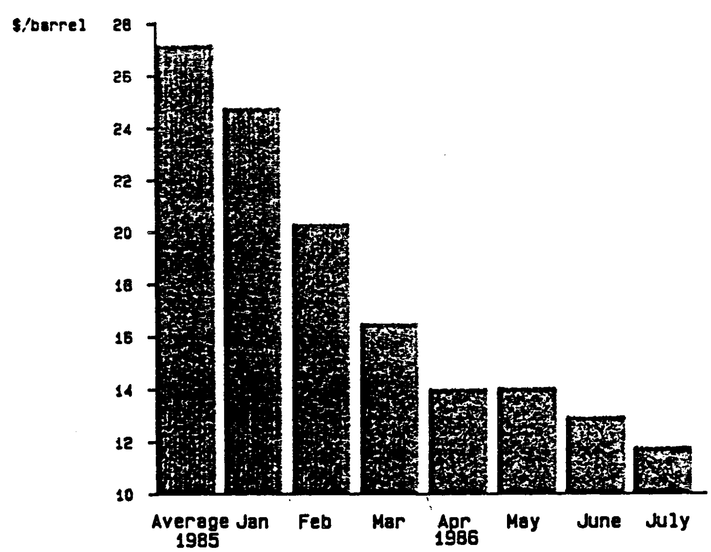


Figure 2

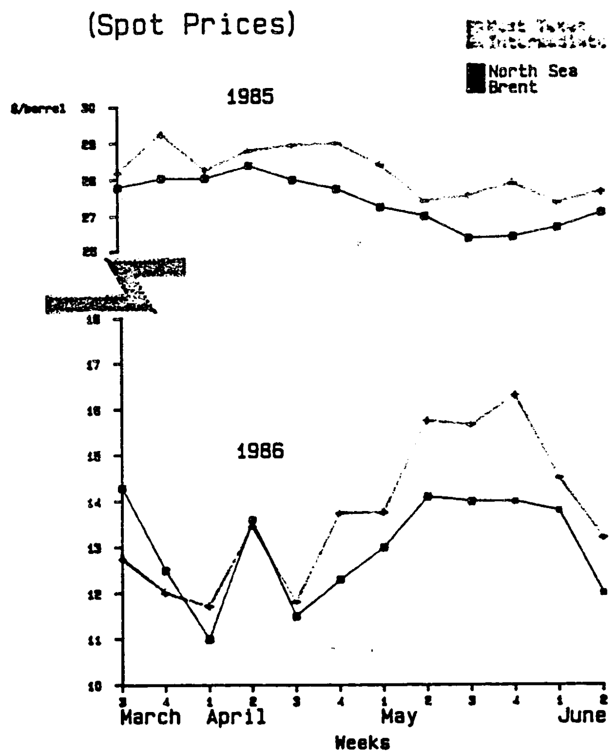
Prices Plummet...

(Average World Price)



...And Are More Volatile

(Spot Prices)



[redacted] 25X1

countries, principally the United States. This assumes OECD real GNP growth of about 2-3 percent above year-earlier levels, roughly what the major forecasting organizations now expect. Oil consumption under these circumstances will approximate 45 million b/d during the third quarter and somewhat over 47 million b/d in the winter heating season (see table). In general this forecast is consistent with prices of about $10 per barrel. It could prove to be on the high side, however, if economic activity in the industrialized countries falters. [redacted] 25X1

<u>Inventory Overhang.</u> Under normal circumstances we would expect a seasonal inventory drawdown in the fourth quarter of less than one million b/d. It could prove much larger this time, however, because of the large inventory overhang accumulated in recent months. This unusually high stock accumulation was driven largely by buyers' expectations that prices would rise later this year to the $18 per barrel level. This is unlikely to happen--and the market is rapidly coming to recognize that it will not--and buyers may now decide that inventories are in fact far too high and accelerate the destocking that normally occurs. If this process happens too rapidly it would contribute to price volatility. Indeed, the high inventory accumulation that occurred in recent months probably prevented prices from falling even further than they have. [redacted] 25X1

<u>Non-Saudi Supply.</u> Although non-OPEC producers lost market share early this year, most have become more competitive in an attempt to recapture market share. Consequently, we expect their output to rebound by several hundred thousand b/d during the rest of the year, although some high-cost production in the United States and Canada is unlikley to come back on stream.

- o Mexican liftings, down substantially in the first half, have rebounded to about 2.8 million b/d and could remain at these levels through yearend. [redacted] 25X1

- o Production increases--expected prior to the price plunge--in Colombia, Brazil, Syria, and Angola are still likely.

- o Net Communist exports have been increasing steadily since March and are expected to continue at least at current levels for the next several months. [redacted] 25X1

OPEC countries other than Saudi Arabia will want to produce about 14 million b/d in our view. Financial pressures will prevent OPEC's poorer members--Nigeria, Indonesia, and Venezuela--from reducing output substantially. Indeed, Venezuela's oil minister recently claimed that Caracas will increase exports by about 200,000 b/d over the course of the year. Even wealthier

[redacted] 25X1

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Non-Communist Oil Supply and Demand Balance

(million b/d)

	1986				
	I	II	III[1]	IV[1]	Year[1]
Total Consumption[2]	46.7	44.2	45.3	47.4	45.9
Inventory Change	-1.0	1.7	0.7	-1.0	0.1
Supply	45.7	45.9	46.1	46.4	46.0
Non-OPEC	26.7	26.2	26.4	26.5	26.5
OPEC	19.0	19.7	19.7	19.9	19.5

	1985				
	I	II	III	IV	Year
Total Consumption[2]	46.6	43.3	43.6	45.9	44.9
Inventory Change	-2.6	0.2	-0.2	0.7	-0.6
Total Supply	44.0	43.5	43.4	46.6	44.3
Non-OPEC	26.3	26.8	27.3	27.6	27.0
OPEC	17.7	16.7	16.1	19.0	17.3

[1]These figures are projections based on assumed trends in OPEC and non-OPEC production and the average price around $10.

[2]Excludes refinery gains and includes natural gas liquids.

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[redacted] 25X1

OPEC states have suffered from the lower oil prices and countries like the UAE, Kuwait, and Qatar appear adamant to keep oil exports at a high level. [redacted] 25X1

Saudi Oil Production Policy. Saudi Arabia will play the key role in determining market conditions over the balance of 1986. The Saudis now hold about 15 percent of the world oil market--about 6 million b/d. If Riyadh is determined to maintain this share of the market and demand fails to grow as market analysts are forecasting--either because of excessive destocking or slow economic growth--prices could drop well below the $10 per barrel level and stay there until other producers back out. The Saudi dilemma is that at $10 per barrel Riyadh's oil revenues approximate $18 billion annually, below the level Saudi Arabia earned last year. Even if Riyadh adjusted its present stance and decided to shave output to bolster prices it may not work. Specifically, Riyadh has no guarantee that other producers would not replace Saudi supplies. [redacted] 25X1

We continue to believe that Riyadh would like to see prices stabilize, at least for a while, at around the $15 per barrel level. At this price we believe that the Saudis would be comfortable with a production level of about 4.5 million b/d--enough to generate a revenue flow of roughly $20 billion. The 4.5 million b/d level would also assure Riyadh's position as the world's largest oil exporter, a goal we believe was important to Riyadh when it initiated the market share fight last August. We doubt, however, that the Saudis will substantially reduce production to achieve the $15 per barrel price level unless they are reasonably certain that others will not simply increase their market share at Saudi expense. The major risk Saudi Arabia runs may be the danger of retaliation from Iran if Riyadh is unyielding on the production front. Tehran is pushing for higher prices and if diplomatic pressures fail to convince Riyadh to stabilize prices, we are concerned that Iran may increase pressure on Saudi Arabia. [redacted] 25X1

[redacted] 25X1

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Intext Box

OPEC and Non-OPEC: An Unlikely Partnership

In the wake of the recent price collapse, we cannot rule out that nonmembers might join OPEC in an international production-sharing pact to stabilize the market. Norway's new government, for example, recently met with an OPEC minister and indicated it might be willing to support higher prices by limiting future increases in output. If 1986 is an example, any such coalition will be shrouded in distrust and guided by a "you first" principle. The non-OPEC oil producers that have expressed a possible willingness to cooperate this year--Oman, Egypt, Mexico, Malaysia, Brunei, Angola and China-- have said that any cutbacks are contingent upon a new OPEC output ceiling substantially below current production levels. Moreover, the cutbacks they have suggested are less than the amount already reduced because of lost market share in earlier rounds of the price war. 25X1

In our view, attempts to maintain a long standing agreement between OPEC and nonmembers probably would be thwarted. The wide divergence in interests among all oil producers likely would lead to the same kind of violations that currently plague OPEC and would work to undermine an international production-sharing pact. For example, the major non-OPEC exporters--the UK, Norway, and Canada--are industrialized nations with larger, more diversified economies and are less dependent than OPEC on oil for revenue. In addition, non-OPEC LDCs striving for energy self-sufficiency are unlikely to join in an effort that would dampen their production prospects. 25X1

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